Top Emerging Risks 2021

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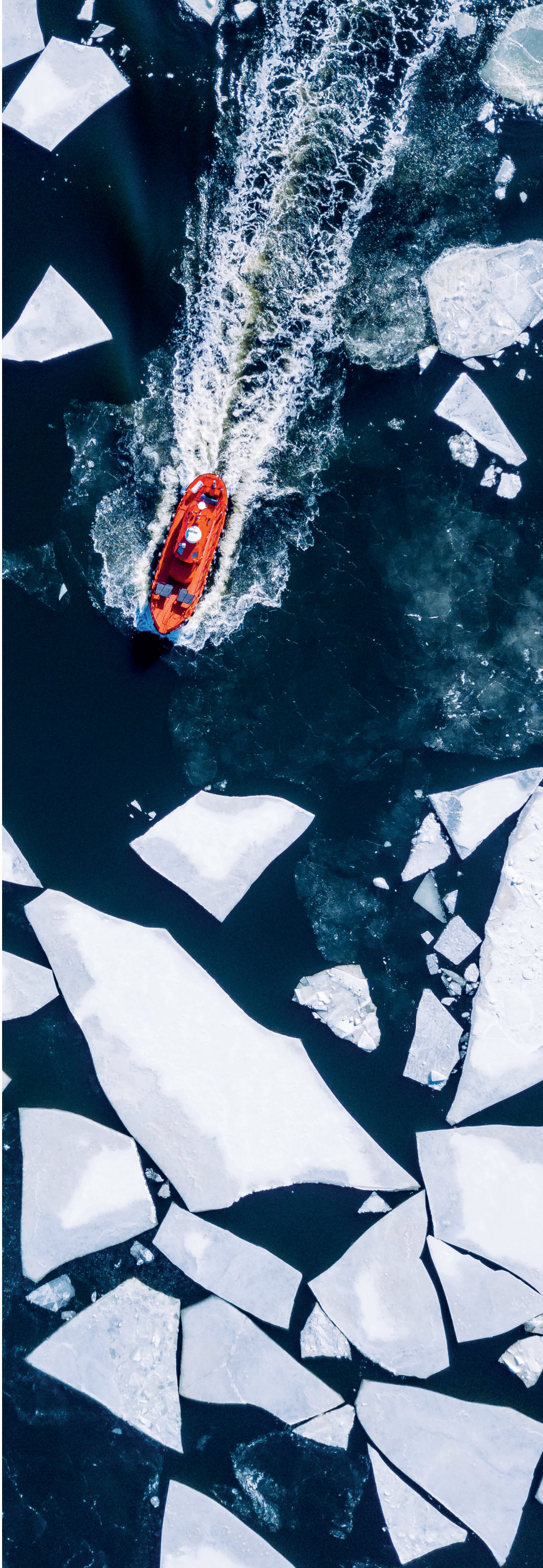
Introduction

This year we shall have not one but several vaccines to fight the novel coronavirus. Even so, despite the mass immunization campaign, we will have to cope with the legacy of the pandemic for a long time. This will be no different for companies. Many of them will start 2021 facing significant difficulties, and the consequences of having had to take extraordinarily complex decisions in a very short time.
In this context, we discussed this matter with several members of Boards of Directors, Supervisory Boards (Conselhos Fiscais) and Audit Committees and some KPMG specialists, to bring the top emerging risks for the 2021 agenda. This publication, in its 3rd. edition, is an initiative of the ACI Institute Brazil and the Board Leadership Center of KPMG Brazil. We hope that the following reflections are useful - and that 2021 is a less turbulent year.



Geopolitical issues and investments in 5G

In Brazil, the consequences of the tension between the US and China will be influenced, to a certain extent, by the result of the US presidential elections and the posture of its new government. Joe Biden's approach to Latin America may consider a resumption of multilateralism, prioritizing sustainability and local manufacturing agendas, and the desire to limit the growing influence of China in the region.
"In general, Biden's regional policies will probably be guided by a more left-oriented Democrat Party, which will have an impact on trade and environmental policies. This situation should not change the US approach to the Chinese presence in Latin America, and particularly in Brazil," explains Sophie Heading, Global Geopolitics, Global Clients & Market Lead, KPMG International. The US is pressuring Brazil to prevent China from participating in the 5G supply chain for 5G infrastructure in the country. Despite resistance on the part of certain industry players, who already rely heavily on equipment from Chinese companies, the US insisted on pressuring, drawing attention to the potential risks to national security, and executing a US$1 billion memorandum of understanding (MoU) in credit to Brazilian companies, with 5G technology as its first priority. Brazil's final decision, however, will only be taken in 2021 and, under Biden's government, Brazil will probably face a colder relationship with the US, including a significant increase in pressure on its environmental policy.

The Eurasia Group's analysis point out that, allowing China to be a significant player in the supply of 5G technology to local operators would possibly have less consequences than originally forecast. In addition to the fact that Biden's leadership is likely to be more reluctant to adopt punishing behavior toward allies who do not follow US guidance. Moreover, the potential legal limitations are not a priority. The Brazilian government could issue a prohibition through decree on a national security basis; however, this may be challenged in courts, by public sector inspection bodies, which may view the veto as a violation of the regulations related to public tenders. Agricultural interests may also have an influence on the Brazilian congress as they may fear a potential trade retaliation and, therefore, would be against any type of limitation on the Asian technology. In any case, this entire situation would pose a challenge to the government, and considerably delay the implementation of 5G technology in the country.

General Data Protection Law

The General Data Protection Law (LGPD) was scheduled to come into effect in August 2020, in Brazil. Four months before its effective date, the Federal Government issued an executive act aiming to postpone its effectiveness to May 2021, in response to requests from small and medium-sized enterprises, which would not have enough time to adapt to the new rules in the middle of the Covid-19 pandemic. From April to August 2020, there was considerable debate in the market as to whether the law would come into force that year, or actually be postponed. After a lot of indecision in the Brazilian house of representatives and senate, the president sanctioned the executive act with no postponement of the effectiveness. As a result, the LGPD officially came into force on September 18, 2020. Many companies were not well prepared for the law on the date it came into force, either because they had expected it to be postponed or because they had not given it the necessary attention. Numerous companies only started to act in order to be in compliance with LGPD a few months ago. "The adaptation is complex, and it takes several years to complete. Also due to the fact that a lot of aspects are still outstanding. For example, the LGPD imposes minimum standards related to data privacy and information security; however, it is the National Data Protection Authority (ANPD), a federal entity which is still being created that will regulate this matter," explains Samara Schuch, Director of Cyber Security, KPMG in Brazil. Despite this, after the LGPD came into effect, authorities such as the Public Prosecution Service (Ministério Público), the Judiciary Branch, and other consumer protection bodies started to investigate cases and even enforce fines, not based on the LGPD, but under the aegis of the consumer protection law. Corroborating the importance of the matter, one recent survey conducted by KPMG in the US identified that 87% of the US consumers classified data privacy as a human right. Another survey, conducted by FireEye, a company specializing in cybersecurity, showed that 78% of consumers are concerned with the ability of companies to keep their data safe and 80% of them would cancel services as a result of data leakage. In the same survey 52% of consumers stated that they would be willing to pay more for the same product/service, should it provide more security to their personal data.

Data-driven market

Companies are tending to adopt a business model that will be increasingly based on data. Personal information becomes more valuable day-by-day, and this situation may be translated into strategic assets for the business. The data-driven market is an irreversible global trend. In contrast to what common sense suggests, it is not focused only on tech companies. This is because data is valued by the market as a whole. Consumers in a number of industries have become used to the personalized experiences offered to them. They now demand this treatment from all companies with which they have a relationship. Consequently, companies must be able to customize their goods and services, and anticipate the expectations and needs of their consumers, in order to offer services that increasingly adapt to their lifestyle. How can all this be done? By means of predictive analyses of an enormous quantity of data. However, in order to have access to those data, the confidence of the consumer must be gained, so that they are willing to share this information. The safer and more transparent the organization proves to be, the more confident the consumer becomes, and the more likely they will be to share their data. As a result, the company may invest in predictive analysis of those data, associating the outcome of those analyses with the customization and anticipation of expectations in relation to its goods and services, thus becoming more competitive, accumulating more value and becoming more targeted by cyber criminals – that issue will require even greater investments in security. "Given that the regulation in Brazil is very recent, companies do not yet grasp the real necessity of making those investments. They invest in security and transparency because they are required to do so by law, without noticing that the most compelling justification for the adaptation is not the regulatory agency's requirement itself, but rather a matter of competitiveness: if the company does not transform its product/service into a customized experience for the consumer, it won't survive in the market," warns Samara Schuch, Director of Cyber Security, KPMG in Brazil. Another point for attention is understanding that being compliant does not necessarily result in assurance. A company may be totally compliant to the law and end up being a victim of a cyberattack, if there is no appropriate resilience and cyber defense strategy in place.

"Given that the regulation in Brazil is very recent, companies do not yet grasp the real necessity of making those investments"

On the other hand, if the company ensures security and transparency, gains the confidence and meets the expectations of the consumer, and adds value to its business, it increases the risk of becoming a potential target to hackers. Therefore, it is necessary to be prepared. What are the main types of attacks? What are the cyber criminals' motivations? What are the increasingly sophisticated aspects of those attacks? Based on these questions, the company should be capable of choosing investments efficiently, in order to set a coherent cybersecurity strategy which, ultimately, ensures the company's operating continuity and continued relationship with the customer.

Bias and prejudice in the use of Artificial Intelligence

As Artificial Intelligence (AI) starts to take front line in interactions between companies/government and customers/ society, gaining an understanding of the process of how AI is created, developed and implemented becomes increasingly important. After all, what guarantee does the Board of Directors have, for example, that the company's AI process effectively assesses potential risks related to prejudicial bias which may be within the data model, the programming team or even the job itself which the AI was designed to improve? Gaining an understanding of the extent to which prejudice - whether conscious or unconscious - is embedded in the strategy, establishment and outcomes of the AI processes will be essential to successfully navigate the next few years.

The quality of the insights provided by AI is directly related to the accuracy of the algorithms. Currently, the issue is that most of the data that comprise those algorithms, on which AI depend, originates in human activity. As a result, that data may have the risk of including an inherent human prejudice element, which may impair the supposed "impartial" analysis that AI proposes to deliver. In an interview with KPMG'S Board Leadership Center, Miriam Vogel, President and CEO of EqualAI (a not-for-profit organization focused on diminishing the unconscious prejudice in the development and use of AI), stated: "I found out that the best manner to deal with unconscious prejudice is to bring the subject of diversity of thoughts to the table. In the future, there will be AI programs that will help us identify and solve prejudice cases in AI, but those programs will also require diversity of thought and different perspectives in order to develop effectively." One of the most efficient strategies to identify and prevent the occurrence of prejudice may be to keep the teams in charge of the algorithm training focused on this matter, jointly with an independent review of the most critical models in which bias might generate an adverse social impact.

The control and mastery of sophisticated algorithms is the essential principle for ethical Artificial Intelligence. "No algorithm will be reliable if it isn't ethical and precise. It needs to be designed and built in a structured way right from its conception, so it's prejudice-free and preserves its equity as it evolves", ponders Leandro Marco Antônio, Partner Technology Risk and Cybersecurity, KPMG in Brazil and South America. The purpose and aims of algorithms should be clear and properly documented. Likewise, data used to train these algorithms should be relevant, particularly appropriate for the task they intend to accomplish, and authorized for use - as in some cases personal information may be significant for the model. In those situations, additional attention should be given to this matter, given the requirements to protect personal data under the General Data Protection Law (LGPD) already in force in Brazil.

Pix: the first steps have been taken towards implementing Open Banking in Brazil

The operating model of the Financial Services industry and possible strategies for its transformation have been the subject of significant reflection. Part of this discussion derives from the possibility of new players in the financial system, specifically through the implementation of the Open Banking model in Brazil.

The Brazilian Central Bank (BACEN) defines open banking as the sharing of data, products and services by financial institutions and other licensed institutions, at the customers' discretion through the opening and integration of platforms and infrastructures of information systems. This model brings opportunities and risks, intrinsic to financial activities, applicable both to the current players in the financial system and those companies that plan to develop new ways of exploiting it. In both cases, successful participation will require the structuring of a project including a clear strategic view of its purposes and limitations. For Cláudio Sertório, Sector-Leader of Financial Services, KPMG in Brazil, this project should be part of the day-to-day agenda of management, addressed as part of the strategic plan, and it should also take into account aspects such as: I) operating model, with attention to the type of offering, partnerships, level of specialization and sources of financing; II) technological structuring, from a preparation perspective of data sharing and also information security; III) assessment of how the client's experience is intended to be enhanced; IV) training program for professionals, particularly in relation to client service and risk management; and, finally, V) mapping new potential process risks and the respective effects to the business.

Those aspects may be noted in the development and implementation of Pix, which is the initial step of the BACEN´S Open Banking - the sharing of data by all financial institutions on one single open platform. Pix enables monetary transfers and other services to be performed, instantaneously and free of charge (for individuals), real time, every day of the year, including weekends and holidays, through a smartphone or Internet banking. The ease and accessibility, novelties in Brazil, also pose new risks to be evaluated and addressed. Kryptus, a hardware manufacturer specializing in encryption and information security, has mapped three threats to transactions in the new payment system . See details in the highlighted chart at the top of this page.

In addition to being attentive to the potential threats, it is essential that the institutions are in compliance with market and regulatory standards and rules. Investing in appropriate technologies and other security adaptations, in order to protect data, processes and clients, is a priority.

1 — **Theft of private keys of the financial institution:** the action enables an invader to pretend to be the institution, and to authorize financial transactions, for instance. In that case, the criminal exploits a vulnerability, and obtains access to the system.

2 — **QR Code scam:** the fraud consists of invading the system environment, changing the QR Code generating code and creating a fake version, illegally diverting the cash;

3 — **Invasion of the cell phone:** may occur as a result of the theft of telephone or any other device belonging to the client. As a result, the criminal may use credentials and perform transactions in the name of the victim.

Environmental, Social and Governance: a holistic approach

If, in the past, ESG matters were referred to, or discussed, briefly by management or the Board of Directors, stakeholders and shareholders activism on ESG matters have brought it to the top of their agenda. As a result of the Covid-19 pandemic, the attention drawn to the theme has only accelerated. A significant growth has been noted in discussions about ESG, particularly regarding factors related to the letter "S" in the acronym, evidenced by the actions the companies needed to address regarding their employees' health and well-being as a result of the pandemic crisis - and also by the growing pressure of shareholders and stakeholders for diversity on Boards. The wave of protests against racial prejudice in the US in the last few months is a further related matter to be considered. There are also issues related to the E of Environmental. Brazil accounts for 2.2% of the total emissions of greenhouse gas, which places the country among the 10 largest emitters in the world. This fact, together with growing concern about biodiversity loss, explains why the Amazon Rainforest has become one of the greatest priorities on the green agenda worldwide. Amid the great international repercussion against our current local environmental policy, the trade agreement between the EU and Mercosur was postponed, and Brazilian companies already fear boycotts by consumers in developed markets. In addition, as a result of the recent presidential election in the US, international pressure on the Brazilian policy with respect to the Amazon may grow significantly, thus reinforcing the extreme importance of the "E".

The ESG pillars are based on humanitarian issues which involve the whole of society such as racism, social and gender inequality; matters related to the environment and discussions on the structure and operation of the governance bodies within companies. "As a result of the growing discussions on the matter, the big risk posed to companies in 2021 is not addressing the ESG theme in a holistic manner. When ESG is discussed, we are not solely talking about one of the letters of the acronym separately, i.e. ESG does not only have to do with an environmental issue, social issues or corporate governance practices in an isolated manner. ESG encompasses those three pillars as a whole; therefore, it is essential that the matter be viewed and treated in an integrated manner, as those pillars are part of the same structure, and just looking at them in an isolated manner does not represent what is expected from ESG", explains Sidney ITO, CEO of the ACI Institute Brazil, and Partner of Risks and Governance Advisory of KPMG. Correct and effective treatment of ESG issues begins with establishing an appropriate corporate governance framework, which is committed to, and able to accomplish the "E" and "S" goals and, thus, generate credibility, as a result of interaction with the community, employees, clients, and other stakeholders. ESG should be be built-in to, and an integral part of, the company's culture, values and long-term planning, and management should be fully engaged, and monitoring the achievement of established ESG goals which should be linked to part of its compensation.

Effects of the Covid-19 pandemic on the financial statements and other disclosures to the market.

The consequences of the coronavirus pandemic will have an impact on companies' financial statements in 2020 and will certainly require attention and detail in their disclosures. Therefore, companies must be attentive to the measurement and disclosure requirements of the effects and risks deriving from the Covid-19 pandemic on the financial statements and other information disclosed to the market. "Organizations have the responsibility and legal obligation to disclose material information to the investors and market in general, on an ongoing basis. The industries most impacted by the pandemic, should be more attentive to best practices and legal requirements for their disclosures", stresses Rogério Andrade, Audit Professional Practices Partner, KPMG in Brazil. Management should be prepared to assess risks and the materiality of the information to be disclosed, as well as their format and context. The required and useful information in the financial statements on the effects arising from the Covid-19 pandemic, which will be disclosed in the notes, should be carefully assessed. Transparent communication between the Board of Directors, Audit Committee, Management, Independent Auditors and other market agents may be decisive in anticipating issues. Below is a list of some items that shoud be considered within the Covid-19 context:

— Focus on **contingencies**, in particular on legal and labor matters, which may generate legal proceedings due to a number of situations triggered by the pandemic. Same for possible disputes and litigations with vendors, lessors, clients and financial institutions.

— Analyze possible situations which may result in the need for **asset impairment**. In a scenario of uncertainty, the forecast of future results and cash flows becomes more complex. This situation means measurement of possible impairment losses has to take into account the likelihood of a number of possible future scenarios; thus, the exercise of judgment, on the part of the financial statement preparers, is significantly increased. Focus also on disclosures that should fully meet the standards so they are clear and objective.

— **Covenants**: in general, companies have directed their attention to compliance with covenants in loan and financing agreements as of the reporting date. This is because, in the event of non-compliance with those clauses, there may be significant consequences to the companies' financial position. For example: when there is a "breach" of covenant, eliminating the company's unconditional right of settling the debt on the originally established date, in the absence of an agreement (waiver) on the part of the creditor before the reporting date, the company may be required to present the total amount of the debt as being due in the short term. The point for attention - and which is often not on the preparers' radar - is that if that forecasts regarding profit or loss, cash flows, financial position, etc., indicate a possible breach of covenants in the next 12 months, and if the company has not yet obtained a waiver from creditors, these debts should be considered short-term liabilities in the mandatory analysis of the assumption of going concern to be prepared by management, which may result in material uncertainty with respect to the company's ability to continue operating over the next 12 months. This scenario requires a series of disclosures on the part of the company, and may have significant consequences in the assessment and independent auditors` report.

— **Going concern** making forecasts in the current scenario may be a complex and challenging exercise. The point of attention is the fact that assumptions previously used may no longer reasonable under a stress situation. The ability of a company to renew credit lines or access the capital markets may have undergone significant changes as a result of the current scenario imposed by the Covid-19 pandemic. Accordingly, throughout the preparation of the forecasts, it is necessary to evaluate whether the assumptions which are not under the companies' control, such as not-contracted credit lines, or future transactions in the capital market, should be taken into account.

Fraud and non-compliance

On March 20, 2020, as a result of the coronavirus pandemic, the Federal Government decreed a state of emergency in the country. Among other measures, declaring the state of emergency exempts the Government from complying the Public Tender Law (8.666/93), which establishes the principles that govern public tenders and other administrative contracts throughout the country, states and municipalities. "The flexibilization of the Public Tender Law opens up the potential for countless types of frauds deriving from the government procurement processes, including embezzlement and theft. There will certainly be a great impact on the relationship with public agents", warns Fernanda Flores, Forensic Partner of KPMG in Brazil. Interaction with public entities such as, for example, in cases involving emergency contracting and donations, increases the chances of more scrutiny by regulatory agencies, both during and after the crisis - particularly on account of the unique circumstances in which these interactions took place. It is already possible to perceive that companies are concerned with this issue. Covid-19: A Compliance Survey, conducted by KPMG in Brazil, pointed out adaptation to emerging risks as one of the most important impacts reported by the Chief Compliance Officers (CCOs) of the companies. Among these emerging risks, fraud, corruption and misconduct, fostered by factors such as donations, the need for engaging new third parties and new regulations and procedures are the ones bringing more concern. "The best tool companies can have to protect themselves against these types of issues is well designed and effective internal control, which brings reliability to the processes and ensures that new and different interactions are not misinterpreted, avoiding any damage to the company's reputation", says Fernanda.

"Controls control processes, but processes have changed and the existing internal controls may not be as efficient as they were before the pandemic"

The pandemic affected practically all levels of organizations - including the Compliance department and the internal control environment – which were significantly impacted at the beginning of the pandemic, and will continue to be challenged by the new post-pandemic reality. This is because most internal controls were designed and implemented to work with teams working on-site; however, as a result of the pandemic, those controls had to be suddenly changed. "Controls control processes, but processes have changed and the existing internal controls may not be as efficient as they were before the pandemic. Different processes may bring new risks; therefore, it is essential that those controls be adapted to the new reality," explains Raphael Soré, Partner of Forensic Investigation, KPMG in Brazil. Disruption in the supply chain abruptly halted interaction with third parties, for example. This might have forced the company to quickly change vendors or business partners and, as a consequence, the due diligence process may not have been performed appropriately, as the emergency situation required almost immediate actions. This scenario results in significant risks: tax and legal risks related to potential for corruption and threats to reputation, and the risk of a certain supplier delivering sub-standard merchandise/providing poor service, or even not delivering anything or not honoring its payment dues as tax for example. Should any of the aforementioned risks materialize and the transaction includes a governmental entity or a government-owned company, the matter could be in the scope of the Brazilian Anticorruption Law (12.846/2013). "Performing previous due diligences of third-parties before establishing any relationship and monitoring them in an ongoing manner are practices recommended by legislation and part of compliance practices, as the absence of such measure exposes companies to numerous risks, and their executives to the possibility of being charged in the future for noncompliance with their diligence fiduciary duties", warns Raphael Soré. (See additional details on *Third Party Risk Management (TPRM) in KPMG Third Party Risk Management Outlook 2020).*

Tax Reform

The Brazilian tax system is reckoned to be one of the most complex in the world, and plays a key role in the so-called "Brazil cost". In addition, the way that the Brazilian taxation occurs in the country very often forces businesses to organize themselves in an unconventional way, as, in this manner, the tax burden becomes considerably lighter (for example: engaging professional persons in the capacity of service companies, in a process known as "pejotização" - engaging professionals not as employees, but as legal entities). For this reason, specialists in economy and politics list the tax reform as one of the most important federal reforms to be discussed, aiming to encourage the economy's sustainable growth. From a company perspective, the tax reform involves some proposals such as: the harmonization of taxes levied on consumption (the so-called indirect taxes); the tax relief of payroll; changes in corporate income tax and a possible tax on financial transactions. From an individuals' point of view, the tax reform may involve: the taxation of dividends; changes in inheritance tax; wealth taxation; and changes in the income tax rules for individuals, mainly in relation to tax deductions.

Taxation of dividends

The taxation of dividends is a theme that is likely to be widely discussed by the Congress throughout 2021. "One of the amendment proposals most debated are related to the changes on the taxation over dividends, which currently are exempted. There are a number of proposals on that theme in the Congress pipeline, some for more than five years", explains Marcus Vinicius, Tax Lead Partner, KPMG in Brazil and South America. Some argue that taxation of dividends could occur in connection with the decrease in the corporate income tax and the social contribution on net income, which currently corresponds to 34%. It is speculated that the income and social contribution tax rate could be reduced to between 20% and 25%, and an additional levy on dividends between 15% and 20% included. Others argue only for a progressive taxation of dividends or at a fixed rate of 15%. Finally, there is an interpretative tendency that argues for the maintenance of the current model, including the exemption of dividends, as they derive from corporate profit, which has already been subject to income and social contribution taxes.

Wealth taxation

Another point for attention which is still under discussion at the Congress is wealth taxation, by means of the creation of a Wealth Tax. There are already 35 draft bills in the national congress pipeline which address the creation of this new tax. In general, the proposals presented feature many differences; however, there is a certain level of consensus around taxing equity exceeding R$22 million (or even the individual taxation of goods according to their nature) at a rate which may range between 0.5% and 2.5%.

"It is worth stressing the fact that the wealth tax has already been established in the Brazilian Federal Constitution, but has never been regulated and implemented," says Vinicius.

Changes in inheritance and donation tax

As it relates to taxes at the state level, many specialists are analyzing the change in rules regarding the inheritance tax (ITCMD) which is levied on inheritances and donations. As it is a state tax, the rate varies according to each state, and the maximum rate that may be established is 8%. Many states adopt rates below the cap. In São Paulo; however, there is a draft bill in the state legislature pipeline which establishes doubling the current rate of 4% to the cap of 8%, in addition to reducing the exemption value and establishing changes in the manner the calculation is performed.

Individual income tax

The Federal Government has been making statements, through the press, on studies that are underway and include the possibility of reviewing income tax rules for individuals. There is no draft bill on the aforementioned theme thus far, but there is speculation that the changes may involve the creation of additional brackets in the progressive tax rates, and the elimination of a series of deductions currently authorized. For example: those related to health and education. Given that as yet no formal proposal has been presented, we are unable to estimate any impacts, but the theme should be monitored during 2021.

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